

**Prepared Statement of Shelton Cannon
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**Virginia General Assembly Joint Subcommittee
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It is a pleasure to appear before you today to talk about Independent System Operators (ISOs) and their possible role in the restructuring of the electric utility industry. I know it is an area of intense interest at both the State as well as the Federal level.

My remarks today are loosely organized around five general areas:

1. A little history about ISO policy at the FERC;
2. ISO development in the wake of FERC's Open Access Rule for Electric Transmission;
3. The basis for FERC's jurisdiction over ISOs;
4. Why we believe ISOs are a good idea; and
5. Some of the upcoming issues we will face.

I'd then be happy to address any questions you may have.

A Short History -- Order 888

About two years ago, the FERC issued an important new regulation designed to bring competition to the wholesale power market and deal with the problem of stranded costs. That regulation (Order 888) required all public utilities that own, control, or operate transmission facilities used in interstate commerce to file non-discriminatory, open access transmission tariffs with the FERC.

The Commission was concerned that vertically-integrated utilities could use their ownership of transmission facilities to favor their own generation. To prevent this, Order 888 required "functional unbundling" of wholesale generation and transmission service.

Functional unbundling requires a utility to:

1. Quote separate rates for wholesale generation and transmission service;
2. Take wholesale (and unbundled retail) transmission service under its own transmission tariff;
3. Provide and rely upon same time access to transmission information -- through the OASIS.

But we faced a dilemma of what to do with power pools. Power pools are complex power sales arrangements under which multiple utilities agree to share (or pool) their generating resources. There are many different kinds of power pools, but, by definition, they generally include favorable transmission arrangements for members of the power pool to trade electric energy with one another. We wanted to preserve the substantial benefits and cost savings associated with existing power pools. But we also wanted to find a way to ensure that the transmission arrangements in the pooling agreements did not provide a loophole around the non-discrimination requirements of Order 888. Accordingly, in Order 888, the Commission directed that existing power pools reform their agreements in a manner that would ensure open membership and non-discriminatory transmission access to all wholesale market participants.

The Commission suggested that one way for existing power pools to comply with the open access requirements of Order 888 would be through the formation of Independent System Operators. ISOs provide a way for public utilities to "operationally unbundle" by transferring operation and control of transmission assets to an independent entity. In that sense, ISOs represent somewhat of a middle ground between functional unbundling (as I described earlier) and corporate divestiture.

The Commission set out eleven principles for the major power pools to follow in forming ISOs. I have included those eleven principles as an attachment to my prepared statement. The eleven principles focus on issues such as ISO governance, operational control, transmission reliability, and transmission pricing.

Developments Since 888

Since Order 888, the Commission has received and acted on ISO filings by each of the three major power pools -- the Pennsylvania-New Jersey-Maryland Power Pool, the New England Power Pool, and, most recently, the New York Power Pool. These were each in the nature of compliance filings to satisfy the non-discriminatory open access requirements imposed by Order 888.

But we are seeing ISOs continue to develop in other contexts, as well. For example, some utilities are forming ISOs at the urging of their state corporation commission or their state legislature. Texas and California were the first two States to require their utilities to transfer operational control of their transmission systems to an ISO.

Other utilities are voluntarily forming ISOs for a variety of reasons. Some because they see it as making good business sense in the brave new world of competitive generation. Others see ISO formation as inevitable and simply hope to play a greater role in shaping the type of institution that develops. Whatever the reason, there are on going discussions in almost every region of the country. In the materials I distributed, I have included a list (as well as a map) that shows the extent of ISO activity. In all, FERC has approved four ISOs. The Midwest proposal is pending. And several other proposals are under discussion around the country.

FERC Jurisdiction

What is FERC's role in all of this beyond having encouraged the formation of ISOs in Order 888? FERC's authority to compel utilities to form ISOs is, at best, unclear. Indeed, in testimony before Congress, our Chairman specifically asked the Congress to:

clarify the Commission's authority to order establishment of, and participation in, regional transmission institutions such as ISOs. ISOs clearly are interstate institutions that can significantly enhance the competitive bulk power market as well as retail markets. . . . I recommend that any legislation . . . leave the Commission with sufficient flexibility

to take into account the regional needs and historical structure of the transmission system in various parts of the country.

However, once the decision is made to form an ISO, FERC has undisputed authority over two things. First, under section 203 of the Federal Power Act, the Commission must approve the transfer of ownership or control over transmission facilities to another entity. For example, before Virginia Power could transfer operational control of its transmission grid to an independent system operator, FERC would have to approve the transfer of transmission facilities.

Second, upon formation, an ISO is subject to rate jurisdiction at the FERC. That is, the rates, terms, and conditions under which an ISO will provide interstate transmission service must be filed and approved by the FERC under section 205 of the Federal Power Act (and similarly would be subject to complaint procedures under section 206 of the Federal Power Act).

Why are we encouraging ISOs?

First and foremost from our perspective, ISOs have the ability to facilitate good open access transmission. By placing all of the transmission facilities in a sufficiently large region under common control, ISOs can unify and standardize the terms and conditions of transmission service across the region. More importantly, an ISO can provide a platform for more efficient pricing of transmission service -- internalizing loop flow problems, eliminating rate pancaking, and permitting regional management of congestion. An ISO can even be a forum for identifying and relieving transmission constraints and recommending needed expansions to the transmission grid.

Second, I believe that ISOs are a good tool for addressing residual vertical market power problems. Transferring operational control of transmission facilities to a truly independent system operator can ensure that decisions regarding who gets to use the transmission system are made in a non-discriminatory fashion without regard to who owns the generating resource. I would note that the Commission has received numerous complaints alleging that some utilities are continuing to use transmission systems in ways that favor their own sales of generation. In that sense, ISOs clearly go further than the

functional unbundling requirements of Order 888, simplify issues related to policing standards of conduct, and limit the opportunity of transmission owners to exclude competitors in the bulk power market.

Finally, ISOs can help promote fully competitive power markets, allowing greater reliance on market-based power rates. ISOs can expand the universe of available generation suppliers, encourage greater market entry by non-traditional suppliers, and facilitate trading opportunities. As states continue experimenting with retail competition, I believe ISOs have the potential to play a critical role in making retail competition succeed.

Emerging Issues

With regard to emerging issues, let me assure you that we have more questions than answers at this point. To begin developing answers to these questions, we have held a series of technical conferences -- beginning with a two-day conference at our offices in Washington on April 14-15 -- and followed up by seven regional conferences held around the country which we concluded last month -- including one here in Richmond. The level of interest and participation in these conferences has been astounding. Transcripts of all of the proceedings are available on the INTERNET. (I have included directions for how to access FERC's home page and how to retrieve the transcripts electronically, if you are interested.)

I'd like to touch briefly on some of the issues that have been presented which we hope that industry and market participants can help us solve.

Size Issues

From a regional perspective, just how big does an ISO need to be? Without the authority to order mandatory participation, what should we do about ISOs that are too small? Or where there are "holes" because certain transmission owners in a region refuse to participate? Are there natural geographic boundaries for an ISO and should those boundaries necessarily correspond with the geographic markets for trading power?

Governance Issues

How do we ensure full participation by all market players in developing ISO rules and protocols while protecting the legitimate rights of transmission owners? Which is better, an "interested" ISO governing board of stakeholders or a disinterested board? We're seeing both models in filings at the Commission. How should the voting rules be structured to ensure that future decisions are made in a fair and non-discriminatory manner?

Pricing Issues

Many of the benefits I have associated with ISOs are very dependent upon getting the transmission pricing right. But there are many difficult issues involved in trying to achieve regional transmission pricing reform, even though ISOs may be the only way to achieve some of these reforms. Some ISOs are asking the Commission for additional flexibility with regard to the terms and conditions of transmission service. Others are concerned with establishing appropriate incentives for the construction of new facilities. Still others are focused on minimizing the disruption associated with cost-shifting.

Control Issues

Clearly, an ISO needs the authority to operate the transmission system. But does that mean that the ISO must also dispatch generation? Does effective operation of an ISO depend on the operation of some form of market clearing power exchange? What role should ISOs play in ensuring transmission system reliability? Should they act as security coordinators? While some ISOs may voluntarily assume some of these responsibilities, should we require that all ISOs take on such additional responsibilities?

Monitoring Issues

Is it appropriate to have ISOs gather information to help ensure that markets are functioning well? Are there market power disputes or issues that an ISO could resolve in the first instance and avoid having such problems come to the FERC or to state Commissions for resolution?

"Stepping Stone" Issues

We've heard from some that ISOs are merely an interesting diversion on the way to a more fundamental institutional restructuring and that the "end game" will require some form of corporate divestiture. For example, a major utility holding company in the South is proposing to spin off its transmission assets to an affiliated "transco." Others argue that forming an ISO is just too difficult and that something less than an ISO, such as formation of an independent tariff administrator, is appropriate.

I warned you that the Commission had more questions than answers. For the time being, I believe the eleven ISO principles from Order 888 are still a relevant starting point for working our way through many of these difficult issues. But those principles will undoubtedly need to be re-interpreted and adapted as we learn more -- in particular to accommodate an ISO which spans multiple utilities that have not operated historically as a single control area.

In closing, I would add that these are challenging issues at both the Federal and state level. I appreciate the opportunity to share a little bit of FERC's perspective on ISOs. I can assure you that the Commission is committed to an active partnership with the states on these and other issues. We clearly have a lot of work ahead of us as we try to get a better handle on identifying market power problems, resolving areas where state and Federal jurisdiction overlap, and defining an appropriate role for ISOs in the restructured electric utility industry.

I'd be happy to address any questions you may have.